
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



RECOVERY ACT

*Millions of Dollars in Questionable Qualified
Motor Vehicle Deductions Are Being Allowed*

April 15, 2011

Reference Number: 2011-41-037

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

Phone Number / 202-622-6500

Email Address / TIGTACommunications@tigta.treas.gov

Web Site / <http://www.tigta.gov>



HIGHLIGHTS



MILLIONS OF DOLLARS IN QUESTIONABLE QUALIFIED MOTOR VEHICLE DEDUCTIONS ARE BEING ALLOWED

Highlights

Final Report issued on April 15, 2011

Highlights of Reference Number: 2011-41-037 to the Internal Revenue Service Commissioner for the Wage and Investment Division.

IMPACT ON TAXPAYERS

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provides individuals with a Qualified Motor Vehicle (QMV) deduction, which is an additional deduction for State sales tax and excise tax on the purchase of certain motor vehicles. The Internal Revenue Service (IRS) cannot verify whether individuals claiming a QMV deduction are entitled to the deduction at the time their tax returns are processed. Inadequate verification of the QMV deduction increases the risk that taxpayers will be allowed to claim excessive QMV deductions.

WHY TIGTA DID THE AUDIT

This audit was initiated because TIGTA is required to monitor the IRS's implementation of Recovery Act provisions. The objective of our review was to assess the effectiveness of the IRS's efforts to identify individuals erroneously claiming a QMV deduction. The expiration date for the QMV deduction was December 31, 2009.

WHAT TIGTA FOUND

The IRS cannot verify whether individuals claiming a QMV deduction are entitled to the deduction at the time their tax returns are processed. The reason is that individuals do not have to provide any third-party documentation to support that they actually purchased a qualified motor vehicle and, if a qualified vehicle was purchased, the amount paid in sales and excise taxes.

Based on our review of a statistically valid sample of 150 individuals allowed a QMV deduction of less than the amount the IRS

considers excessive, it appears that some individuals may have erroneously been allowed QMV deductions for vehicles that were not purchased.

In addition, the process to identify potentially erroneous QMV deductions is not effective. The IRS failed to identify 4,257 individuals claiming what the IRS defines as an excessive QMV deduction during tax return processing so it could hold and prevent the possible issuance of erroneous tax refunds. These individuals claimed a total of more than \$151.1 million in QMV deductions. TIGTA also identified 473 cases for which information that the IRS maintains identifies the individuals as ineligible to claim about \$1.02 million in QMV deductions they were allowed. These individuals were in prison, deceased, or underage.

Finally, the processes the IRS established to verify the 3,026 QMV deductions the IRS identified as having an excessive claim are also resulting in the erroneous release of tax refunds. Our testing identified that the IRS does not ensure Tax Examiners are taking the necessary steps to verify the QMV deductions.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the Commissioner, Wage and Investment Division, ensure Tax Examiners review the 1,324 excessive QMV deduction claims identified by TIGTA. In addition, a review should be conducted of all tax returns identified as a result of an excessive QMV deduction that met examination criteria but were closed with no reduction in the QMV deduction to ensure Tax Examiners are taking correct actions prior to closing cases. Finally, the IRS should review the tax returns of the 473 individuals TIGTA identified as being in prison, deceased, or underage to evaluate whether these individuals qualify for the deduction.

The IRS agreed with all five of the recommendations. The IRS plans to review all of the cases TIGTA identified, and those cases warranting examination will be selected for audit. The IRS also plans to revise the Internal Revenue Manual procedures for the Tax Examiners reviewing QMV deductions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

April 15, 2011

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: *Michael R. Phillips*
Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Millions of Dollars in Questionable Qualified Motor Vehicle Deductions Are Being Allowed (Audit #201040108)

This report presents the results of our review to assess the effectiveness of the Internal Revenue Service's (IRS) efforts to identify individuals erroneously claiming the Qualified Motor Vehicle deduction. This audit is part of our Fiscal Year 2010 Annual Audit Plan and addresses the major management challenge of Erroneous and Improper Payments and Credits.

The American Recovery and Reinvestment Act of 2009 (Recovery Act)¹ provides separate funding to the Treasury Inspector General for Tax Administration through September 30, 2013, to be used in oversight activities of IRS programs. This audit was conducted using Recovery Act funds.

Management's complete response to the draft report is included in Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services), at (202) 622-5916.

¹ Pub. L. No. 111-5, 123 Stat. 115 (2009).



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Table of Contents

Background	Page 1
Results of Review	Page 4
The Internal Revenue Service Cannot Verify the Qualified Motor Vehicle Deduction at the Time a Tax Return Is Processed	Page 4
The Process to Identify Potentially Erroneous Qualified Motor Vehicle Deductions Is Not Effective	Page 6
Recommendations 1 and 2:	Page 7
Verification Is Inadequate, Which Resulted in the Allowance of Excessive Qualified Motor Vehicle Deductions	Page 8
Recommendation 3:	Page 9
Recommendation 4:	Page 10
Erroneous Qualified Motor Vehicle Deductions Were Allowed to Ineligible Individuals Even Though the Internal Revenue Service Had Data to Identify These Claims During Tax Return Processing	Page 10
Recommendation 5:	Page 11
Appendices	
Appendix I – Detailed Objective, Scope, and Methodology	Page 12
Appendix II – Major Contributors to This Report	Page 15
Appendix III – Report Distribution List	Page 16
Appendix IV – Management’s Response to the Draft Report	Page 17



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Abbreviations

IRS	Internal Revenue Service
QMV	Qualified Motor Vehicle
TIGTA	Treasury Inspector General for Tax Administration



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Background

The American Recovery and Reinvestment Act (Recovery Act)¹ provides individuals with a Qualified Motor Vehicle (QMV) deduction, which is an additional deduction for State sales tax and excise tax on the purchase of certain motor vehicles. For Tax Year 2009 only, individuals could deduct State sales tax and excise tax for qualified motor vehicle purchases after February 16, 2009, and before January 1, 2010. The expiration date for the QMV deduction was December 31, 2009. A qualified motor vehicle is defined as an automobile or light truck with a gross vehicle weight rating of 8,500 pounds or less, a motorcycle, or a motor home (no weight limit).

***The QMV Deduction was for
Tax Year 2009 only and was
intended to stimulate the
sales of automobiles.***

The QMV deduction is claimed on either the Standard Deduction for Certain Filers (Schedule L) or on line 7 of Itemized Deductions (Schedule A). These schedules are then filed with the individual's U.S. Individual Income Tax Return (Form 1040 or 1040A). The amount of qualified taxes is limited to the first \$49,500 of the purchase price of the new vehicle. Individuals can take a QMV deduction for more than one vehicle. For those individuals residing in States with no sales tax (Alaska, Delaware, Hawaii, Montana, New Hampshire, and Oregon) they are entitled to deduct other fees or taxes imposed by the State or local government. These fees or taxes that qualify must be assessed on the car's sales price or as a per unit fee.

The amount of the QMV deduction reduces an individual's taxable income and taxes owed. The QMV deduction is phased out for individuals with a modified adjusted gross income² between \$125,000 and \$135,000 for single individuals and between \$250,000 and \$260,000 for married individuals filing a joint tax return. Individuals with modified adjusted gross income equal to or above the phase-out amounts are not eligible for the QMV deduction. Figure 1 shows the number of individuals claiming the QMV deduction by schedule type and the amounts allowed through November 12, 2010.

¹ Pub. L. No. 111-5, 123 Stat. 115 (2009).

² Modified Adjusted Gross Income is calculated by adding certain items to the Adjusted Gross Income that were excluded, such as foreign housing deductions and savings bond interest.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Figure 1: QMV Deductions for Tax Year 2009

Schedule	Tax Returns	Total QMV Deductions
Schedule A	2,268,421	\$3,846,317,037
Schedule L	2,104,677	\$3,383,703,052
Totals	4,373,098	\$7,230,020,089

Source: IRS Individual Returns Transaction File³ Data through Cycle 46 (November 12, 2010).

The 2010 Filing Season review identified excessive QMV deductions that were not identified by the IRS

The Treasury Inspector General for Tax Administration (TIGTA) 2010 Filing Season report⁴ identified 2,933 individuals with more than \$95.8 million in QMV deductions on Schedule A that had QMV deductions with a dollar amount considered by the Internal Revenue Service (IRS) as being excessive. The IRS established an excessive dollar figure to identify potentially erroneous QMV deductions. The IRS implemented controls to identify and freeze the refund for individuals claiming a QMV deduction in excess of a specific dollar amount on Schedule L. Once the freeze is applied, the tax return is sent to an examiner to determine if the QMV deduction is correct (i.e., the individual purchased a new vehicle). However, similar controls were not implemented to identify excessive QMV deductions claimed on Schedule A.

We recommended that if the QMV deduction is extended, the Commissioner, Wage and Investment Division, should ensure programming is implemented to identify and freeze refunds of individuals claiming more than a specific dollar amount in QMV deductions on Schedule A. This programming should mirror the programming already in place to identify potentially excessive QMV deductions on Schedule L. In addition, Tax Examiners should review the 2,933 individuals whom the TIGTA identified as claiming the QMV deduction on Schedule A that was excessive to ensure these individuals qualify for the deduction. IRS management agreed with this recommendation.

Recovery Act activities require a high level of scrutiny, and taxpayer dollars spent on economic recovery must be subject to unprecedented levels of transparency and accountability. Federal agencies are required to ensure Recovery Act funds are used for authorized purposes and that appropriate measures are taken to prevent fraud, waste, and abuse. As such, the TIGTA is required to monitor the IRS's implementation of Recovery Act provisions. This audit was conducted to meet those requirements.

³ The IRS database that contains data transcribed from initial input of the original individual tax returns during return processing.

⁴ *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (Reference Number 2010-41-128, dated September 30, 2010).



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



This review was performed at the Wage and Investment Division Headquarters in Atlanta, Georgia, and the Submission Processing Site in Fresno, California, during the period September 2010 through January 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Results of Review

The Internal Revenue Service Cannot Verify the Qualified Motor Vehicle Deduction at the Time a Tax Return Is Processed

The IRS cannot verify whether individuals claiming a QMV deduction are entitled to the deduction at the time their tax returns are processed. This is a result of individuals not having to provide any third-party documentation supporting that they actually purchased a qualified motor vehicle and, if a qualified vehicle was purchased, the amount paid in sales and excise taxes. Instead, the IRS relies on individuals claiming the QMV deduction to comply with tax laws and to provide correct information on their tax returns. This includes accurately reporting income and claiming only the tax benefits and credits to which they are entitled. Figure 2 illustrates key requirements for claiming the QMV deduction that the IRS cannot verify at the time a tax return is processed.

Figure 2: Key Requirements for Claiming the QMV Deduction

Key Requirement	Able to Verify Requirement When the Tax Return Is Processed?
Was a Motor Vehicle(s) Purchased?	No
Was a Motor Vehicle Purchased Between February 16, 2009, and January 1, 2010?	No
Motor Vehicle Purchase Price.	No
Amount of Sales/Excise Tax Paid.	No

Source: IRS procedures and Tax Form instructions.

Further, the limited information that is required to be provided by an individual in support of a QMV deduction depends on the tax schedule the individual uses to claim the deduction. Figure 3 provides a comparison of the information requested to be provided to claim the QMV deduction on either Schedule A or Schedule L.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Figure 3: Information Requested on Schedules A and L

	Data Requested on Schedule?	
	Schedule A	Schedule L
Vehicle Purchase Price	No	Yes
Sales/Excise Tax Paid	No	Yes
Sales Tax Claimed	Yes	Yes

Source: Tax Year 2009 Schedule A and Schedule L Instructions.

Some QMV deductions may have been for vehicles that were not purchased

We reviewed a statistically valid sample of 150 individuals allowed a QMV deduction of less than the amount the IRS considers excessive. To determine if a new vehicle was purchased, we used third-party vendor information that the IRS uses when examining questionable QMV claims. This information is provided to the third-party vendor from State Departments of Motor Vehicles and/or from other independent sources that have access to public records. However, the third-party information is limited to those States that provide vehicle records to the vendor. For those individuals in States that do not report vehicle information, we attempted to contact the Departments of Motor Vehicles within those States to confirm the purchase of a new vehicle. Our review identified:

- 65 individuals purchased a new vehicle.
- 60 individuals for whom the State or third-party vendor had no record of a new vehicle purchase. These individuals claimed \$64,934 in QMV deductions.
- 25 individuals for whom we were unable to obtain information as to whether they purchased a new vehicle because they live in States that did not provide vehicle records to the third-party vendor and the Departments of Motor Vehicles had not responded to our requests for verification as of January 12, 2011.

We did not project a noncompliance rate to the population using this sample because of the potential for omissions or errors in this type of third-party reporting.

The QMV deduction expired on December 31, 2009, and has not been extended by law. As such, we are not including specific recommendations to address the IRS's inability to verify the QMV deduction at the time a tax return is processed. However, if similar legislation is enacted in the future, the IRS should require individuals to provide more information on their tax returns in support of the vehicle deduction. For example, the IRS could require individuals to provide a vehicle identification number or the name and address of the dealer from which the vehicle was purchased. Requesting additional information could serve as a deterrent for those individuals who may intend to claim erroneous vehicle-related credits and/or deductions.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



The Process to Identify Potentially Erroneous Qualified Motor Vehicle Deductions Is Not Effective

Although the IRS recognized the potential for individuals to abuse the QMV deduction, the process for identifying and working the potentially abusive QMV deductions was not effective. As we reported in our 2010 Filing Season report, the IRS did not establish a process to identify individuals who use Schedule A to claim QMV deductions totaling more than the dollar amount the IRS used to identify potentially erroneous claims.

During the 2010 Filing Season review, we identified 2,933 individuals with more than \$95.8 million in QMV deductions. These deductions were claimed during the period January 1 through May 28, 2010. The IRS responded that it would initiate action to verify these deductions. As of December 15, 2010, the IRS has not verified the accuracy of these QMV deductions. The IRS noted that Tax Examiner review of these excessive claims will not begin until July 2011, which for some individuals would be 19 months after the QMV deductions were allowed.

Additional analysis of tax returns filed between May 29 and November 12, 2010, with QMV deductions claimed on Schedule A identified another 462 individuals with excessive deductions. The IRS implemented controls to identify and freeze the refund for individuals claiming a QMV deduction in excess of a specific dollar amount on Schedule L. Similar controls, however, were not implemented to identify excessive QMV deductions claimed on Schedule A. Because these controls were not in place, these individuals received their tax refunds, unlike those individuals with excessive QMV deductions claimed on Schedule L. For the Schedule L filers, the IRS procedures are to hold these tax refunds until a Tax Examiner verifies the legitimacy of the QMV deduction to prevent the issuance of a potentially erroneous refund.

On December 29, 2010, we notified IRS management of these 462 individuals claiming more than \$28 million in QMV deductions using Schedule A. We recommended that the IRS obtain supporting documentation for the purchase of new vehicles by the 462 Schedule A filers who were allowed excessive QMV deductions to determine whether the deductions were permissible. IRS management agreed with the recommendation and will ensure the Director, Reporting Compliance, Wage and Investment Division, coordinates with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

We plan to monitor the IRS's progress in verifying the 3,395 potentially erroneous Schedule A QMV deductions we identified and will report the amount of increased tax liability for those QMV deductions disallowed in our annual filing season reports.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Processes are not ensuring excessive deductions claimed on Schedule L are identified

As of November 12, 2010, we identified 862 QMV deductions claimed on Schedule L with deduction amounts above the level which the IRS considers potentially erroneous that were not sent to Tax Examiners for verification. This resulted from Tax Examiners not inputting into IRS computers the required Unallowable Code for these tax returns. As a result, these tax returns were not identified as needing verification. The Unallowable Code is necessary to identify tax returns with potential errors that require verification by a Tax Examiner.

The QMV deductions associated with these 862 claims totaled more than \$27.3 million. It should be noted that because these tax returns were not correctly identified for QMV deductions, the verification of the tax refunds associated with these 862 claims were not held to prevent the possible issuance of an erroneous tax refund.

We alerted IRS management of our preliminary results on November 8, 2010, and recommended that QMV deductions for these individuals be verified to ensure these individuals qualify for the deduction. IRS management agreed with the recommendation and will ensure the Director, Reporting Compliance, Wage and Investment Division, coordinates with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

We plan to monitor the IRS's progress in verifying the 862 potentially erroneous Schedule L QMV deductions we identified and will report the amount of increased tax liability for those QMV deductions disallowed in our annual filing season reports.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 1: Ensure Tax Examiners review the tax returns of the 462 individuals who TIGTA identified as claiming the QMV deduction on Schedule A during the period May 29, 2010, to November 12, 2010, to ensure these individuals qualify for the deduction.

Management's Response: IRS management agreed with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

Recommendation 2: Ensure Tax Examiners review the tax returns of the 862 individuals who TIGTA identified as claiming the QMV deduction on Schedule L to ensure these individuals qualify for the deduction.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Management's Response: IRS management agreed with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

Verification Is Inadequate, Which Resulted in the Allowance of Excessive Qualified Motor Vehicle Deductions

For those cases meeting IRS examination criteria, the IRS is not requesting or receiving documentation supporting the purchase of a QMV prior to closing these tax returns as warranting no reduction in the QMV deduction and associated tax refund. As a result, individuals received more than \$73,418 in questionable tax refunds.

We identified 3,026 individuals claiming approximately \$104 million in QMV deductions on Schedules L processed through June 4, 2010, that were identified by the IRS as having a deduction of more than the amount which the IRS classifies as excessive. The results of the IRS's verification of these tax returns as of July 31, 2010, are as follows:

- 944 (31 percent) were not verified for QMV deduction eligibility, which includes 17 individuals who qualified for examination relief through Combat Zone Tax Relief. These tax returns claimed QMV deductions totaling \$30 million.
- 1,152 (38 percent) were in the process of being verified.
- 930 (31 percent) were verified and tax assessments were made on \$40 million in QMV deductions claimed.

Our review of a judgmental sample of 120 of the 944 tax returns closed with no reduction to the QMV deduction identified:

- **Cases incorrectly closed without documentation supporting excessive QMV deductions.** Our review identified 53 (44 percent) of 120 tax returns met the IRS's dollar criteria for initiating an examination. However, all 53 cases were incorrectly closed without requesting and/or receiving documentation supporting the purchase of a QMV. IRS management indicated that Tax Examiners did not follow the IRS's Miscellaneous Deduction procedures for examining these tax returns.
- **Cases closed as not meeting the IRS's dollar criteria for examination.** Our review identified 65 (54 percent) of 120 tax returns did not meet the IRS's dollar criteria for initiating an examination and were closed with no reduction to the amount of the QMV deduction. The IRS uses the dollar criteria in an effort to maximize limited Tax Examiner resources. To meet the dollar criteria for initiating an examination, the tax return correction



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



would have to result in a sizeable increase to an individual's taxable income and/or a significant tax or credit change which would affect an individual's refund or balance due.

- **Cases closed that were not subject to enforcement action.** Our review identified *****1***** of 120 tax returns qualified for examination relief through Combat Zone Tax Relief.

The Office of Management and Budget has established five broad requirements that all agencies must follow in order to meet accountability objectives relating to Recovery Act funds. These requirements are posted on the Recovery.gov web site. The third requirement is that Federal agencies ensure Recovery Act funds are used for authorized purposes and take the steps needed to prevent instances of fraud, waste, and abuse. The IRS has not established processes to ensure individuals are appropriately claiming the QMV deduction. In addition to the IRS not requesting any third-party information to verify QMV deductions claimed, the forms used to claim the deduction (Schedule A and Schedule L) do not require individuals to provide information which could serve as a deterrent for those individuals who intend to erroneously claim these deductions.

As we previously mentioned, the IRS failed to identify 4,257 individuals claiming what the IRS defines as an excessive QMV deduction during tax return processing to hold and prevent the possible issuance of erroneous tax refunds. These individuals claimed a total of more than \$151.1 million in QMV deductions.

In addition, the processes that the IRS established to verify the 3,026 QMV deductions the IRS identified as having an excessive claim are also resulting in the erroneous release of tax refunds. Our testing has identified that the IRS is not ensuring Tax Examiners are taking the necessary steps to verify the validity of the QMV deductions, but are instead releasing erroneous refunds even though individuals did not provide required documentation. As such, potentially erroneous refunds are being released without any attempt to verify the legitimacy of the QMV deduction the IRS identified as being excessive and potentially erroneous.

Recommendations

The Commissioner, Wage and Investment Division, should:

Recommendation 3: Review all tax returns identified as a result of an excessive QMV deduction that met examination criteria but were closed with no reduction in the QMV deduction to evaluate whether the Tax Examiners' actions were correct.

Management's Response: IRS management agreed with this recommendation. The IRS will review the 7 returns that were not sent to the Examination function for audit consideration, and will rescreen the 909 returns where Miscellaneous Deduction procedures may not have been followed. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance,



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

Recommendation 4: Ensure Tax Examiners are taking appropriate steps prior to closing excessive QMV deduction cases.

Management's Response: IRS management agreed with this recommendation. The IRS has already revised the instructions for its Tax Examiners. Revisions to the Internal Revenue Manual procedures for the QMV deduction claimed on Schedule A posted to the Servicewide Electronic Research Program on January 31, 2011, and procedures for Schedule L posted on February 16, 2011. These procedures will be published in the January 1, 2012, revision of the Internal Revenue Manual.

Erroneous Qualified Motor Vehicle Deductions Were Allowed to Ineligible Individuals Even Though the Internal Revenue Service Had Data to Identify These Claims During Tax Return Processing

We identified 473 cases for which information that the IRS maintains identifies these individuals as ineligible to claim about \$1.02 million in QMV deductions they were allowed. These individuals were allowed to erroneously claim these deductions because the IRS did not develop procedures to identify individuals who were in prison, deceased, or under the age needed to enter into a contract to purchase a motor vehicle. Figure 4 shows the breakdown of the ineligible individuals who were allowed to erroneously claim the QMV deduction.

***Figure 4: Ineligible Individuals
Who Claimed a QMV Deduction***

Type of Individual	Number of Individuals	Amount Allowed
Prisoner	439	\$955,843
Deceased	16	\$36,490
Under the Age of 15	18	\$31,139
Total	473	\$1,023,472

Source: TIGTA analysis of IRS Individual Returns Transaction File Data.

Prisoners deducted \$955,843 in sales tax for the purchase of vehicles in 2009 even though they were in prison for the entire year

We determined that 439 prisoners who filed tax returns as single or head of household were allowed QMV deductions totaling \$955,843 for the purchase of a vehicle in 2009 even though they were in prison for a full year in 2009 when the vehicle was purportedly purchased. The IRS



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



has data that can be used when a tax return is processed to identify prisoners erroneously claiming this deduction.

Deceased individuals were allowed \$36,490 in QMV deductions

We identified 16 individuals who were deceased prior to the date qualified vehicle purchases must have taken place—after February 16, 2009, and before January 1, 2010. These erroneous QMV deductions totaled \$36,490. The IRS has data that can be used when a tax return is processed to identify deceased individuals erroneously claiming this deduction.

Underage individuals were allowed \$31,139 in QMV deductions

We identified 18 individuals under the age of 15 who were allowed \$31,139 in QMV deductions. Standard business practice generally does not permit a minor to enter into a contract to purchase a motor vehicle. The IRS has data that can be used when a tax return is processed to identify the age of the individuals erroneously claiming this deduction.

We plan to monitor the IRS's progress in verifying the 473 tax returns with these unlikely claims. We will report the amount of increased tax liability for those QMV deductions disallowed in our annual filing season reports.

Recommendation

Recommendation 5: The Commissioner, Wage and Investment Division, should ensure Tax Examiners review the tax returns of the 473 individuals we identified as being in prison, deceased, or underage to ensure these individuals qualify for the deduction.

Management's Response: IRS management agreed with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self-Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to assess the effectiveness of the IRS's efforts to identify individuals erroneously claiming the QMV deduction. To accomplish this objective, we:

- I. Assessed the actions taken by the IRS to identify erroneous QMV claims.
 - A. Participated in a walkthrough at the Submission Processing Site in Fresno, California, and identified the efforts taken by IRS Tax Examiners to identify erroneous QMV claims.
 - B. Interviewed IRS management and analysts in Code and Edit, Error Resolution, and Examination functions to identify steps taken to verify the accuracy of QMV claims.
- II. Determined if the IRS ensured whether 4,365 individuals claiming QMV deductions in excess of the QMV deduction limit on Standard Deduction for Certain Filers (Schedule L) qualified for the deduction.
 - A. Identified Tax Year¹ 2009 individual income tax returns with 1,339 Schedule L QMV deductions claimed over the QMV deduction limit with no appropriate Unallowable Codes totaling \$547,826,101 processed nationally on the Individual Return Transaction File² between January 16 and June 4, 2010,³ to determine whether the excessive QMV deductions were allowed. Of these 1,339 QMV deductions claimed, we identified 761 tax returns where the deductions were actually allowed. Subsequently, we identified another 101 Schedule L tax returns with excessive QMV deductions from the IRS's Individual Return Transaction File, which contained 90,046 Schedule L QMV deductions totaling \$141,295,141, between June 5 and November 12, 2010.
 - B. Identified Tax Year 2009 individual income tax returns with 3,026 Schedule L QMV deductions claimed over the QMV deduction limit with certain Unallowable Codes

¹ Tax Year is the period of time when records are kept and income is reported on a tax return. For most people, it is a calendar year.

² The IRS database that contains data transcribed from initial input of the original individual tax returns during return processing.

³ To assess the reliability of computer-processed data, programmers in the TIGTA Office of Information Services validated the data that were extracted, and we verified the accuracy of the data by reviewing the IRS's Integrated Data Retrieval System for a judgmental sample of 25 individuals. The Integrated Data Retrieval System is an IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



totaling approximately \$104 million processed nationally on the Individual Return Transaction File from January 16 to June 4, 2010, to determine the results of examination by the IRS. We selected a judgmental sample of 120 tax returns from the no change examination results where the individuals' Adjusted Gross Income was greater than \$10,000 to determine whether the IRS contacted the individual for documentation to support the QMV deduction. A judgmental sample was taken because we wanted to show a control weakness to prompt management to take corrective action.

III. Determined if individuals accurately claimed the QMV deduction on their tax returns.

- A. Selected a statistically valid sample of 150 tax returns filed in Tax Year 2009 and processed between January 16 and June 4, 2010, from the Individual Return Transaction File that contained 4,113,849 records of individuals who were allowed a QMV deduction equal to or less than the QMV deduction limit on Itemized Deductions (Schedule A) and Schedule L that totaled about \$5.9 million to assess the actions taken by the IRS to validate this deduction. We used attribute sampling to calculate the minimum sample size n , which was rounded to 150:

$$n = (Z^2 p (1-p)) / (A^2)$$

Z = Confidence Level: 90 percent (expressed as 1.65 standard deviation)

p = Expected Rate of Occurrence: 5 percent

A = Precision Rate: ± 3 percent

Used a third-party research tool to locate motor vehicle records and determine the validity of the date of purchase. When the third-party research tool did not have motor vehicle information, we contacted the Departments of Motor Vehicles to obtain motor vehicle records for the States where the individuals who claimed the QMV deductions on their tax returns resided.

- B. Determined the potential lost revenue for individuals who were allowed the QMV deduction in error by using a statistical projection.

IV. Identified prisoners who were allowed the QMV deduction and determined if prisoners accurately claimed the deduction.

- A. Matched individuals who claimed the QMV deduction on Tax Year 2009 tax returns to the IRS's 2009 Prisoner File and identified prisoners who were allowed the QMV deduction.
- B. Matched only Prisoner File individuals in single or head of household status.
- C. Matched only Prisoner File individuals in jail for the entire tax year.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



- V. Determined whether the IRS allowed ineligible individuals the QMV deduction.
 - A. Identified QMV deduction accounts that showed a date of death prior to February 17, 2009.
 - B. Identified QMV deduction accounts where the individual was under the age of 15.
- VI. Identified corrective actions the IRS planned to initiate to ensure individuals who claimed QMV deductions over the QMV deduction limit on Schedule A qualified for the deduction.
 - A. Followed up with the IRS to determine if the 2,933 Schedule A tax returns with a QMV deduction of more than the QMV deduction limit that TIGTA identified in the 2010 Filing Season audit⁴ have been examined.
 - B. Subsequently, we identified 462 Schedule A tax returns with excessive QMV deductions from the Individual Return Transaction File which contained 164,911 Schedule A QMV deductions totaling \$286,857,125 between June 5 and November 12, 2010.
 - C. Followed up with the IRS and determined whether programming has been implemented to identify and freeze the tax refunds of individuals who claimed more than the QMV deduction limit on Schedule A.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the American Recovery and Reinvestment Act of 2009,⁵ Internal Revenue Manual, *Standards for Internal Control in the Federal Government*,⁶ and the IRS's policies, procedures, and practices for processing the QMV deduction. We evaluated these controls by interviewing management, examining applicable information, and reviewing samples of tax returns with QMV deductions.

⁴ *Verifying Eligibility for Certain New Tax Benefits Was a Challenge for the 2010 Filing Season* (Reference Number 2010-41-128, dated September 30, 2010).

⁵ Pub. L. No. 111-5, 123 Stat. 115 (2009).

⁶ *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1).



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Appendix II

Major Contributors to This Report

Michael E. McKenney, Assistant Inspector General for Audit (Returns Processing and Account Services)

Russell P. Martin, Director

Edward Gorman, Audit Manager

Gwendolyn Gilboy, Lead Auditor

Karen Fulte, Senior Auditor

Kathleen Hughes, Senior Auditor

Jonathan Lloyd, Auditor

Marcus Sloan, Auditor

James Allen, Information Technology Specialist

Robert Carpenter, Information Technology Specialist



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner of Operations, Wage and Investment Division SE:W
Deputy Commissioner of Services, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Electronic Tax Administration and Refundable Credits SE:W:ETARC
Director, Accounts Management, Wage and Investment Division SE:W:CAS:AM
Director, Filing and Payment Compliance, Wage and Investment Division SE:W:CP:FPC
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Chief, Program Evaluation and Improvement, Wage and Investment Division
SE:W:S:PRA:PEI



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



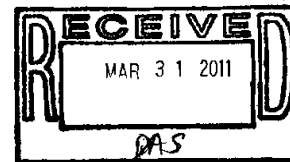
Appendix IV

Management's Response to the Draft Report



COMMISSIONER
WAGE AND INVESTMENT DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308



MAR 31 2011

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr. *Richard Byrd*
Commissioner, Wage and Investment Division

SUBJECT: Draft Audit Report – Millions of Dollars in Questionable Qualified
Motor Vehicle Deductions Are Being Allowed
(Audit #201040108)

We have reviewed your draft report on the administration of the Qualified Motor Vehicle (QMV) deduction. The Treasury Inspector General for Tax Administration's (TIGTA) assessment of the IRS' effectiveness in identifying and addressing erroneous claims of a QMV deduction identified areas where we have already implemented changes to strengthen controls, or are in the process of doing so. The QMV deduction was an additional deduction for State or local sales tax, or excise tax on the purchase of certain motor vehicles, made after February 16, 2009, and before January 1, 2010. This was a temporary deduction that is no longer available. It was generally deductible by taxpayers as an itemized deduction on Schedule A, *Itemized Deductions*, or as an increase to the standard deduction amount for those taxpayers who did not, or could not, itemize their deductions. The QMV deduction was subject to certain limitations based on the purchase price of the vehicle, and reductions, or phase-outs, based on adjusted gross income.

As noted in your report, over 4.3 million taxpayers claimed the QMV deduction through November 12, 2010. Your report identifies a small percentage of cases in which taxpayers may have claimed questionable QMV deductions. We agree these returns are worthy of additional scrutiny and we will review them. Any of these cases warranting exam will be audited. If this deduction or a similar deduction is enacted in the future, our efforts to work with the Social Security Administration to identify deceased individuals and minors, and our efforts to work with Federal and State prison systems to identify prisoners, will serve to subject these kinds of returns to special scrutiny for examination.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



2

We would also like to clarify a point regarding the reporting of cases as having been closed incorrectly because supporting documentation was not requested of the taxpayer. Of the 944 returns identified by TIGTA, 909 were reviewed by Examination personnel and found to have no potential for change to the reported tax liability that would warrant initiating an examination, and contacting the taxpayer. After subsequent review of TIGTA's findings, we agree that the classifiers may not have consistently followed procedures for Miscellaneous Deductions. We will perform a second review of those returns and initiate examinations when warranted. While we appreciate that the screening process could have been performed better, we felt that the report could mistakenly lead one to believe that the returns were audited and closed without change to the tax liability. Of the remaining 35 cases, seven returns should have been forwarded to Examination for consideration but were not. Those seven returns will also be considered with the 909 that will be rescreened. Of the remaining 28 returns, 17 qualified for Combat Zone relief from examination, and 11 were examined and closed. Those returns will not be rescreened.

Attached is our response to your specific recommendations. If you have any questions, please contact me, or a member of your staff may contact Steve Klingel, Acting Director, Reporting Compliance, Wage and Investment Division, at (404) 338-8983.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



Attachment

The Commissioner, Wage and Investment Division, should:

RECOMMENDATION 1

Ensure Tax Examiners review the tax returns of the 462 individuals who TIGTA identified as claiming the QMV deduction on Schedule A during the period May 29, 2010, to November 12, 2010, to ensure these individuals qualify for the deduction.

CORRECTIVE ACTION

We agree with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

IMPLEMENTATION DATE

April 15, 2012

RESPONSIBLE OFFICIAL

Director, Compliance, Wage and Investment Division
Director, Campus Compliance Services, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 2

Ensure Tax Examiners review the tax returns of the 862 individuals who TIGTA identified as claiming the QMV deduction on Schedule L to ensure these individuals qualify for the deduction.

CORRECTIVE ACTION

We agree with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

IMPLEMENTATION DATE

April 15, 2012

RESPONSIBLE OFFICIAL

Director, Compliance, Wage and Investment Division
Director, Campus Compliance Services, Small Business/Self Employed Division



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



2

CORRECTIVE ACTION MONITORING PLAN

The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 3

Review all tax returns identified as a result of an excessive QMV deduction that met Examination criteria but were closed with no reduction in the QMV deduction to evaluate whether the Tax Examiners' actions were correct.

CORRECTIVE ACTION

We agree with this recommendation. We will review the seven returns that were not sent to Examination for audit consideration, and we will rescreen the 909 returns where Miscellaneous Deduction procedures may not have been followed. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self Employed Division to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

IMPLEMENTATION DATE

April 15, 2012

RESPONSIBLE OFFICIAL

Director, Compliance, Wage and Investment Division
Director, Campus Compliance Services, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 4

Ensure Tax Examiners are taking appropriate steps prior to closing excessive QMV deduction cases.

CORRECTIVE ACTION

We agree with this recommendation. We have already revised our instructions for our tax examiners. Revisions to Internal Revenue Manual (IRM) procedures for the Qualified Motor Vehicle deduction claimed on Schedule A, *Itemized Deductions*, posted to the Servicewide Electronic Research Program (SERP) on January 31, 2011, and procedures for Schedule L, *Standard Deduction for Certain Filers*, posted to SERP on February 16, 2011. These procedures will be published in the January 1, 2012, revision of the IRM.



*Millions of Dollars in Questionable
Qualified Motor Vehicle Deductions
Are Being Allowed*



3

IMPLEMENTATION DATE

January 15, 2012

RESPONSIBLE OFFICIAL

Director, Compliance, Wage and Investment Division

Director, Campus Compliance Services, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

The IRS will monitor this corrective action as part of our internal management control system.

RECOMMENDATION 5

The Commissioner, Wage and Investment Division, should ensure Tax Examiners review the tax returns of the 473 individuals we identified as being in prison, deceased, or underage to ensure these individuals qualify for the deduction.

CORRECTIVE ACTION

We agree with this recommendation. The Director, Reporting Compliance, Wage and Investment Division, will coordinate with the Director, Campus Reporting Compliance, Small Business/Self Employed Division, to ensure these cases are reviewed, and cases warranting examination will be selected for audit.

IMPLEMENTATION DATE

April 15, 2012

RESPONSIBLE OFFICIAL

Director, Compliance, Wage and Investment Division

Director, Campus Compliance Services, Small Business/Self Employed Division

CORRECTIVE ACTION MONITORING PLAN

The IRS will monitor this corrective action as part of our internal management control system.